

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
F. W. Woolworth Co. :

: AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law :
for the Fiscal Year Ended 1/31/77. :

State of New York :

ss.:

County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 12th day of June, 1985, he served the within notice of Decision by certified mail upon F. W. Woolworth Co., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

F. W. Woolworth Co.
Woolworth Bldg.
New York, NY 10279

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
12th day of June, 1985.

David Parchuck

Bennie D. Hagelund

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
F. W. Woolworth Co. :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law :
for the Fiscal Year Ended 1/31/77.

State of New York :
ss.:
County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 12th day of June, 1985, he served the within notice of Decision by certified mail upon Michael D. Bray, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Michael D. Bray
19 Rector St.
New York, NY 10006

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
12th day of June, 1985.

David Parchuck

Annie G. Hagelund

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

June 12, 1985

F. W. Woolworth Co.
Woolworth Bldg.
New York, NY 10279

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 Months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Michael D. Bray
19 Rector St.
New York, NY 10006
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
	:	
of	:	
	:	
F. W. WOOLWORTH CO.	:	DECISION
	:	
for Redetermination of a Deficiency or for	:	
Refund of Franchise Tax on Business Corporations :	:	
under Article 9-A of the Tax Law for the Fiscal	:	
Year Ended January 31, 1977.	:	

Petitioner, F. W. Woolworth Co., 233 Broadway, New York, New York 10279, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the fiscal year ended January 31, 1977 (File No. 37478).

A formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on June 6, 1984 at 1:15 P.M., with all briefs to be submitted by November 28, 1984. Petitioner appeared by Michael Bray, Esq. The Audit Division appeared by John P. Dugan, Esq. (Patricia L. Brumbaugh, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly disallowed a portion of petitioner's interest expense paid or accrued on long- and short-term debt as indirectly attributable to subsidiary capital.

II. Whether the formula employed by the Audit Division to attribute interest expense to subsidiary capital was proper.

III. Whether the allocation of interest expense to certain functionally independent subsidiaries contravenes the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

FINDINGS OF FACT

1. Petitioner, F. W. Woolworth Co. ("Woolworth"), timely filed its franchise tax report for the fiscal year ended January 31, 1977, calculating its tax based on allocated net income. Petitioner reported federal taxable income in the amount of \$98,436,093.00; in arriving at entire net income, petitioner excluded dividends from subsidiary capital of \$76,994,298.00 as permitted by Tax Law section 208.9(a)(1), but made no allocation of interest expense to subsidiary capital. Petitioner's fiscal year 1977 federal taxable income reflected a deduction for interest expense paid or accrued on debts and liabilities in the categories and amounts shown below.

Long-term debt

5% promissory notes issued 1957/58	\$ 1,449,467
25 year debentures issued 1971	8,876,017
25 year debentures issued 1974	11,250,000
25 year debentures - deferred charge	48,208
8½% bank notes issued 1974	3,309,041
	<u>\$24,932,733</u>

Mortgage Loans

Various	\$ 475,373
Alton, Illinois	11,663
Hanover, Massachusetts	43,213
	<u>\$ 530,240</u>

Short-term debt

Bank loans	\$ 8,581,923
Revolving loan - interest	6,186,885
Revolving loan - commitment fee	137,554*
Commercial paper	4,235,143
	<u>\$19,141,505</u>

Tax deficiencies

LIFO adjustment	\$ 123,224
State, city and federal taxes	26,282
	<u>\$ 149,506</u>

* Misclassified as interest

Other

Spokane, Washington lease cancellation	\$ 43,163
Employee stock purchase	33,490
	<u>\$ 76,653</u>

Total per federal return \$44,830,646

2. On April 15, 1982, the Audit Division issued to Woolworth a Notice of Deficiency, asserting franchise tax due under Article 9-A of the Tax Law for the fiscal year ended January 31, 1977 in the amount of \$78,157.00, plus interest. The only audit adjustment underlying the asserted deficiency which remains in dispute is the Audit Division's disallowance of a portion of petitioner's interest expense as indirectly attributable to subsidiary capital. The Audit Division calculated the indirect attribution as shown below.

(a) Net interest expense	
Interest expense per federal return	\$ 44,830,646
Less: tax deficiency interest	(26,282)
Net interest expense	<u>\$ 44,804,364</u>
(b) Cost of applicable subsidiary capital	
Average cost of subsidiaries - Form 1120	\$ 95,992,250
Less: Austrian subsidiary	(1,528)
Average cost of all subsidiaries	<u>\$ 95,990,722</u>
Average advances to Canada subsidiary	68,494
Total	<u>\$ 96,059,216</u>
Less: cost of preferred stock exchanged for The Richman Brothers Company	<u>(8,465,922)</u>
Total cost of applicable subsidiary capital	<u>\$ 87,593,294</u>
(c) Net total assets	
Average total assets per federal return	\$1,374,488,708
Less: retained earnings of subsidiaries	(305,717,228)
Total assets - corrected	<u>\$1,068,771,480</u>
Less: cost of stock exchanged for The Richman Brothers Company	<u>(8,465,922)</u>
Net total assets	<u>\$1,060,305,558</u>
(d) Indirect attribution	
\$44,804,364 x \$ 87,593,294	
<u>\$1,060,305,558</u>	= \$3,701,333

In accordance with additional information subsequently supplied by petitioner and a concession made by counsel to the Audit Division, the following items were excluded from the interest attribution:

Tax deficiency interest	
LIFO adjustment	\$123,224
State, city and federal taxes	26,282
Spokane, Washington lease cancellation	43,163
Employee stock purchase	33,490
Mortgage loans	
Various (per petitioner's workpapers)	475,373
Alton, Illinois	11,663
Hanover, Massachusetts	43,213
Revolving loan - commitment fee	<u>137,554</u>
Total	<u>\$893,962</u>

Consequently, the only categories of interest expense at issue herein are interest paid or accrued in the amount of \$24,932,733.00 on long-term debt and interest paid or accrued in the amount of \$19,003,451.00 on short-term debt.

3. Woolworth is a New York corporation engaged in the retail business throughout the United States, Puerto Rico, and the Virgin Islands. It purchases a variety of consumer items, including dry goods, artwork, appliances, candy and some packaged food and sells them at retail through Woolworth and Woolco stores. Most of the stores also serve fountain items and meals.

4. Petitioner maintains its headquarters at the Woolworth Building in New York City and maintains a central accounting office in Milwaukee, Wisconsin. Among other responsibilities, the central accounting office monitors the funding requirements of the retail stores and the corporate headquarters, receives monies from the operation of the retail stores, prepares weekly budgets and apprises the headquarters on a daily basis of the anticipated financial needs for that day. Funds are required by the retail stores to purchase inventory; to construct, maintain and enlarge the stores; to pay

salaries; to finance credit sales; and to meet all other operating expenses. Headquarters requires funds to operate the Woolworth Building, to pay dividends to shareholders, to make payments of principal and interest on indebtedness, to remit tax installments and to make investments in and advances to subsidiaries. Considering all these requirements, the treasurer ascertains the necessity for and incurs short-term indebtedness.

5. During fiscal year 1977, the sources of Woolworth's short-term borrowings were bank loans, revolving loans and sales of commercial paper. Because of the seasonal nature of retailing, the amount of short-term credit peaks during the Christmas season to support the bulge in inventories and receivables. Thus there exists a close correlation between petitioner's inventory build-up and its liability on short-term debts.

<u>MONTH END</u>	<u>INVENTORY</u>	<u>SHORT-TERM LOANS</u>
January 1976	\$520,328,033	\$148,950,000
February 1976	512,820,986	184,525,000
March 1976	557,856,249	223,631,000
April 1976	674,299,625	226,925,000
May 1976	715,577,964	272,260,000
June 1976	711,839,920	321,660,000
July 1976	696,990,537	310,963,000
August 1976	720,969,597	351,120,000
September 1976	774,007,112	359,423,000
October 1976	776,405,000	348,603,000
November 1976	797,804,988	390,055,000
December 1976	622,434,662	172,100,000
January 1977	556,991,779	-0- *

* Excluding \$30 million borrowed on 1/31/77 and repaid within 11 months.

6. Woolworth's long-term indebtedness, approved by the Board of Directors, was incurred to reduce its short-term indebtedness. The treasurer determines at which points the short-term debt reaches such a level as to require funding into long-term borrowing.

(a) In 1957 and 1958, Woolworth issued 5 percent promissory notes in a private placement with the Equitable Insurance Company. Petitioner was unable to provide any evidence regarding the purpose of this issue.

(b) In April, 1971, Woolworth issued \$125 million in 7-3/8 percent sinking fund debentures due April 1, 1996. The prospectus of the debenture issue states the purpose as follows:

"The net proceeds to be received by the Company from the sale of the Debentures offered hereby will be used to reduce the consolidated short-term borrowings of the Company which on March 15, 1971 aggregated \$221,344,000 excluding current maturities of long-term debt. The Company's short-term indebtedness has been incurred for various purposes, including construction and enlargement of stores, carrying of larger retail inventories and the financing of credit sales. The Company intends to provide additional funds for these purposes from internally generated sources, additional borrowings and other financial arrangements."

(c) In 1974, Woolworth issued \$125 million in 9 percent sinking fund debentures due June 1, 1999. The prospectus states the purpose of the issue in the manner set forth below.

"The gross proceeds from the sale of the Debentures are expected to be applied as follows:

Repayment of Short-Term Debt	\$124,063,000
Underwriting Discount & Estimated Expenses	<u>1,328,000</u>
	<u>\$122,735,000</u>

Consolidated short-term borrowings of the Company on April 30, 1974 aggregated \$432,834,000, including current maturities of long-term debt. The Company's short-term indebtedness has been incurred for various purposes, including construction and enlargement of stores, carrying of larger retail inventories and the financing of credit sales. The Company intends to provide additional funds for these purposes from internally generated sources, additional borrowings and other financial arrangements."

(d) The final category of long-term debt on which Woolworth paid or accrued interest during fiscal year 1977 was comprised of two bank loans obtained in 1974 in the aggregate amount of \$40 million at a rate of 8½ percent.

The loan proceeds were utilized for the same purposes as the two above-described debenture issues.

7. During fiscal year 1977, Woolworth owned the following subsidiaries:

<u>SUBSIDIARIES</u>	<u>PERCENT OWNED</u>	<u>BOOK VALUE (COST)</u>	<u>DATE OF INVESTMENT</u>
F. W. Woolworth & Co., Ltd. England	52.7%	\$ 63,176	1909-31
F. W. Woolworth Co., Ltd. Canada	100%	3,200,000	1912-34
F. W. Woolworth Co. GmbH Germany	100%	924,269	1960-63
Krone GmbH	100%	1,464,286	1954-63
F. W. Woolworth & Co. S.A. de C.V. Mexico	100%	2,539,076	1953-56
Kinney Shoe Corporation	100%	34,000,000	1963
Woolworth International Credit Corporation (NY)	100%	20,720,208	1965-77
The Richman Brothers Company Ohio	100%	32,461,971	1969
Color Corp. of America, Inc.	100%	389,714	1976
340 Supply Company	100%	25,000	1975
F. W. Woolworth of Pa.	100%	203,022	1964
		<u>\$95,990,722</u>	

The English, Canadian, Mexican and German subsidiaries are engaged in the business of general merchandise retailing in their respective countries and do no business in New York or any other state in the United States.

The Kinney Shoe Corporation ("Kinney") is engaged in the business of the retail sale of footwear throughout the United States. Woolworth acquired Kinney from Brown Shoe Co. in 1963 for a cash offer.

Woolworth organized Woolworth International Credit Corporation ("WICC") in 1965, contributing to the new subsidiary all the stock of another Woolworth subsidiary, Woolworth Espanola.

The Richman Brothers Company ("Richman") is engaged in the business of the retail sale of men's clothing throughout portions of the United States. Woolworth acquired Richman in a triangular B reorganization (Internal Revenue Code section 368[a][1][B]) whereby a newly formed, wholly-owned Woolworth subsidiary acquired all the Richman shares in exchange for a new preferred issue of Woolworth.

8. All of the subsidiaries operate as discrete business enterprises independent from Woolworth with the exception of F. W. Woolworth of Pa., 340 Supply Co., and Color Corp. of America, Inc., which are small companies performing a single specialized function in connection with Woolworth's domestic operations. All of the subsidiaries maintain independent banking relationships, accounts and lines of credit with various banks. The subsidiaries seek short-term loans, as does the parent company, primarily for the purchase of merchandise. When contemplating long-term borrowing, the subsidiaries do confer with Woolworth.

9. An analysis of Woolworth's investment in its subsidiaries for the ten-year period culminating in the fiscal year at issue is set forth in Appendix A to this decision. Petitioner's total investment in subsidiaries for the fiscal year ended January 31, 1977 was \$420,265,658. With the exception of F. W. Woolworth & Co., Ltd. (England), each investment is reflected in accordance with the equity method of accounting which considers the undistributed earnings of each subsidiary as an addition to the parent's investment in that subsidiary at the end of the year. The English subsidiary is not recorded according to such method because only half its outstanding shares is owned by Woolworth.

The only subsidiary to which Woolworth made cash advances during such ten-year period was WICC; all other increments to its investments in subsidiaries represent undistributed earnings.

10. An analysis of the increases in petitioner's investment account of WICC is displayed below.

MONTHLY ADVANCES BY WOOLWORTH

<u>DATE</u>	<u>PAID-IN CAPITAL</u>
Opening balance 12/68	\$ 853,062
9/69	761,000
7/70	1,200,000
1/71	200,000
2/71	100,000
3/71	100,000
9/74	11,940,146.65
10/74	1,500,000
11/74	100,000
1/75	2,000,000
4/75	210,000
5/75	50,000
6/75	200,000
7/75	280,000
1/76	960,000
1/77	530,000

The substantial increase which occurred in September, 1974 was by reason of a change in accounting method. All other increases were cash advances by Woolworth. Petitioner maintains that the amounts advanced were inconsequential in the context of its sizable borrowings and were most likely derived from operating revenues rather than occasioning a special borrowing.

CONCLUSIONS OF LAW

A. That Tax Law section 208, subdivision 9 furnishes the definition for and method of computing entire net income; paragraph (a), subparagraph (1)

provides that entire net income shall not include "income, gains and losses from subsidiary capital...". Paragraph (b) sets forth those exclusions, deductions and credits which are not permitted in the determination of entire net income and provides, in pertinent part:

"Entire net income shall be determined without the exclusion, deduction or credit of:

* * *

(6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

Generally speaking, the interest expense attributable to subsidiary capital is disallowed as a deduction in order to prevent the taxpayer from reaping a double benefit, inasmuch as the taxpayer is permitted to exclude income from subsidiary capital in the calculation of its entire net income (Matter of World Wide Volkswagen Corp., State Tax Commission, April 30, 1974).

B. That a portion of petitioner's interest expense paid or accrued on short- and long-term indebtedness is properly allocable to subsidiary capital. Petitioner's contention that its investments in its subsidiaries and its advances to WICC are insubstantial is refuted by the evidence presented. The cost of the subsidiary corporations (disregarding WICC and Richman) represents approximately 4.79 percent of petitioner's net total assets (\$50,736,543/\$1,060,305,558); the subsidiaries at value represent approximately 39.64 percent of petitioner's net total assets (\$420,265,658/\$1,060,305,558). Taking into consideration Woolworth's average yearly advances to WICC over the period July, 1970 through January, 1977 (approximately \$1,060,000.00 annually) increases

these percentages by about one-tenth of a point. Petitioner chooses to continue its investment in its subsidiaries, the income from which is not includible in entire net income, where its regular business pattern clearly indicates the necessity for borrowing to meet future recurring needs for working capital (i.e., for the purchase of inventory). There thus exists a sufficiently close relationship between petitioner's indebtedness and its investment in subsidiary corporations to justify the disallowance of a proportionate part of petitioner's interest deduction. (Cf. Rev. Proc. 72-18, 1972-1 C.B. 740, which provides guidelines for the allocation of interest expense to tax-exempt obligations under Internal Revenue Code Section 265[2].)

C. That petitioner failed to demonstrate any error in the formula used by the Audit Division to attribute interest to subsidiary capital. The "net total assets" factor in the formula represents average total assets as reflected in the balance sheets of petitioner's federal corporation income tax return. Further, the "cost of subsidiary capital" factor represents the average cost of the subsidiaries, plus advances to subsidiaries and less the cost of Woolworth preferred stock exchanged for Richman stock; the term "subsidiary capital" embraces investments in the stock of subsidiary corporations, irrespective of whether such subsidiaries yield dividend or other income (Tax Law section 208.4).

D. That the constitutionality of the New York State tax laws and their application in particular instances is presumed at the administrative level of the Tax Commission.

E. That the petition of F. W. Woolworth Co. is denied, and the Notice of Deficiency issued on April 15, 1982 is modified solely to take cognizance of the adjustments and concessions made by the Audit Division (Finding of Fact "2").

DATED: Albany, New York

STATE TAX COMMISSION

JUN 12 1985

Rodwin A. Clev
PRESIDENT

Francis R. Koenig
COMMISSIONER

Mark J. Smith
COMMISSIONER

APPENDIX A

ANALYSIS OF INVESTMENT IN SUBSIDIARIES

	DECEMBER 31,					
	1967	1968	1969	1970	1971	1972
F. W. Woolworth & Co., Ltd. England	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630
F. W. Woolworth Co., Ltd. Canada	88,898,675	97,112,157	106,827,198	117,338,945	127,057,135	141,365,005
F. W. Woolworth Co. GmbH Germany	24,708,157	28,453,207	33,154,732	37,059,315	41,106,044	45,291,793
Krone GmbH	1,464,286	1,464,286	1,464,286	1,464,286	1,464,286	1,464,286
F. W. Woolworth Co. Austria	1,528	1,528	1,528	1,528	1,528	1,528
F. W. Woolworth & Co. SA de C.V. Mexico	2,539,076	2,539,076	2,539,076	2,539,076	2,539,076	2,539,076
Kinney Shoe Corporation	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000
The Richman Brothers Company	--	--	32,461,971	32,461,971	32,461,971	32,461,971
F. W. Woolworth Co. Japan	536,421	536,421	--	--	--	--
F. W. Woolworth Co. Espanola	852,062	--	--	--	--	--
Spanish Realty	761,000	761,000	--	--	--	--
Hurtado	1,000	--	--	--	--	--
F. W. Woolworth of Pa.	203,022	203,022	203,022	203,022	203,022	203,022
Woolworth International Credit Corporation	--	854,062	1,615,062	2,815,062	3,215,062	3,215,062
Greenville	--	--	183,436	4,936,000	4,936,000	--
340 Supply Company	--	--	--	--	--	--
Color Corp. of America, Inc.	--	--	--	--	--	--
	<u>\$184,844,857</u>	<u>\$196,804,389</u>	<u>\$243,329,941</u>	<u>\$263,698,835</u>	<u>\$277,863,754</u>	<u>\$291,422,273</u>
Other receivables	--	--	--	--	--	--
Per tax return	<u>\$184,844,857</u>	<u>\$196,804,389</u>	<u>\$243,329,941</u>	<u>\$263,698,835</u>	<u>\$277,863,754</u>	<u>\$291,422,273</u>

(continued on page A2)

(SHORT PERIOD)
ONE MONTH ENDED
JANUARY 31,

	1973	1974	1975	1976	1977
F. W. Woolworth & Co., Ltd. England	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630	\$ 30,879,630
F. W. Woolworth Co., Ltd. Canada	139,188,713	153,388,814	165,615,655	183,925,998	205,995,500
F. W. Woolworth Co. GmbH Germany	45,291,793	52,867,793	64,519,793	77,326,793	90,801,793
Krone GmbH	1,464,286	1,464,286	1,464,286	1,464,286	1,464,286
F. W. Woolworth Co. Austria	1,528	1,528	1,528	1,528	1,528
F. W. Woolworth & Co. SA de C.V. Mexico	2,539,076	2,539,087	2,539,076	2,539,076	2,539,076
Kinney Shoe Corporation	34,000,000	34,000,000	34,000,000	34,000,000	34,000,000
The Richman Brothers Company	32,461,971	32,461,971	32,461,971	32,461,971	32,461,971
F. W. Woolworth Co. Japan	--	--	--	--	--
F. W. Woolworth Co. Espanola	--	--	--	--	--
Spanish Realty	--	--	--	--	--
Hurtado	--	--	--	--	--
F. W. Woolworth of Pa.	203,022	203,022	203,022	203,022	203,022
Woolworth International Credit Corporation	3,215,062	3,215,062	18,755,208	20,455,208	20,955,208
Greenville	--	--	--	--	--
340 Supply Company	--	--	--	25,000	25,000
Color Corp. of America, Inc.	--	--	--	--	779,429
	\$289,245,081	\$311,021,182	\$350,440,169	\$383,282,512	\$420,136,443
Other receivables	--	--	--	--	129,215
Per tax return	\$289,245,081	\$311,021,182	\$350,440,169	\$383,282,512	\$420,265,658